Supreme Court of the United States,

OCTOBER TERM, 1925.

No. 567.

BOARD OF PUBLIC UTILITY COMMISSIONERS AND HARRY V. OSBORNE, JOSEPH V. AUTENREITH AND FREDERICK GNICHTEL, CONSTITUTING SAID BOARD,

Appellants,

against

NEW YORK TELEPHONE COMPANY,

Appellee.

BRIEF FOR APPELLEE.

CHARLES M. BRACELEN,
THOMAS G. HAIGHT,
CHARLES T. RUSSELL,
FRANKLAND BRIGGS,
Counsel for Appellee.

The Evening Post Job Printing Office, Inc., 154 Fulton St., New York, N. Y.

SUBJECT INDEX.

TABLE OF STATUTES AND CASES CITED.

STATUTES.

CASES.

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Statement of the Case.

This is an appeal from an interlocutory injunction order (R. 240), made by a Court of three judges (Buffington, *C.J.*, Rellstab and Morris, *D.J.J.*) constituted in accordance with the provisions of Section 266 of the Judicial Code and filed on May 12, 1925. The Company has furnished the bond of $2,000,000 thereby required (R. 243). The opinion of the Court below (R. 237) is reported, 5 Fed. (2nd) 245.

The facts leading up to and involved in this litigation are, briefly stated, as follows:

The appellee is a corporation of the States of New York and New Jersey, owning and operating a telephone system and furnishing telephone service in the northeasterly section

of the State of New Jersey, throughout the State of New York, and in a portion of the State of Connecticut (Bill, R. 3). The appellants constitute an administrative Board for the State of New Jersey, possessing regulatory powers in that State over public service corporations (Bill, R. 4).

The territory of the Company in the State of New Jersey is divided into so-called "local areas". The exchange service is service between telephones, or, in telephone parlance, "stations", in the same local area. When the service is between stations in different local areas it is known as toll service (R. 3). Toll service is both intrastate and interstate and the plant and facilities of the company used in furnishing service are used in each kind of service, exchange, toll, intrastate and interstate (R. 8, 74).

For the last ten years prior to the commencement of this suit the rates of the Company in New Jersey, both exchange and toll, have been substantially at the same level. Slight changes were made but there was no general increase involving any substantial addition to the revenue of the company (Bill, R. 5; R. 143-144), although it is a well-known fact that the price of practically everything else has risen during the war-period or in the years immediately succeeding the war. The company, however, was not unaffected by the change in price levels or in the increase in living costs. Higher material prices have caused increases in the cost of all the equipment entering into a telephone system with the result that construction costs for a given amount of equipment are substantially higher than they were in the pre-war period (R. 103-112).

The expense of operating a telephone system consists in large part of wages paid to employees. As living costs rose the company was obliged to increase wages with the result that there has been a large increase in its expenses. During this period of increasing costs, both of construction and of operating expenses, the rate level, as has been stated above, has remained the same; in other words, the company has carried on its business under changed conditions with no

increase in rates. *It has received the same number of dollars for its service but in purchasing power these dollars are now 60 cent as compared with 100 cent dollars in 1914* (R. 145).

Prices for materials and labor costs for the last two or three years have remained at a level which seems likely to be continued for some years to come and there is no probability that falling prices in the near future will restore the condition that existed prior to the war (R. 117). It was this situation which led to the increase in rates proposed by the Company in 1924 and which resulted in the order made by the appellant Board and complained of in this suit.

Under the provisions of the Public Utilities Act of New Jersey (Ch. 195, L. 1911, as amended) the initiative in rate-making remains with the company. There are, however, in Section 17(*h*) of the Act certain provisions applicable when public utilities make increases in rates. The Board is given a limited suspension power and the burden of proof of the reasonableness of the increase is placed upon the utility. The section in question is printed in the footnote.

On March 6, 1924, the company filed with the Board schedules of rates applicable to service in New Jersey to be effective April 1, 1924 (R. 5). The new schedules provided very generally for increases in the rates for *exchange* service; no increase in the *toll* rates was proposed.

The Board on March 11, 1924, made an order providing for an investigation of these new rates and ordered their sus-

"(*h*) When any public utility as herein defined shall increase any existing individual rates, joint rates, tolls, charges or schedules thereof, as well as commutation, mileage and other special rates or change or alter any existing classification, the board shall have power either upon written complaint or upon its own initiative to hear and determine whether the said increase, change or alteration is just and reasonable. The burden of proof to show that the said increase, change or alteration is just and reasonable shall be upon the public utility making the same. The board shall have power pending such hearing and determination to order the suspension of the said increase, change or alteration until the said board shall have approved said increase, change or alteration, not exceeding three months. If such hearing shall not have been concluded within such three months, the board shall have power during such hearing and determination to order a further suspension of said increase, change or alteration for a further period not exceeding three months. It shall be the duty of the said board to approve any such increase, change or alteration upon being satisfied that the same is just and reasonable."

pension until October 1, 1924, but when October 1st was approaching and the investigation was still incomplete, the suspension period was further extended until January 1, 1925, by the consent of the company (R. 6).

On December 31, 1924, the Board made the order complained of in this suit, incorporating therein a decision of considerable length (Exhibit A to the Bill, R. 16 to 70). The order disallowed the increase in rates as filed by the company and stated that at that time no increase in rates would be approved. The order furthermore made specific directions as to the handling of the Company's depreciation expense, prescribed rates therefor and made adjustments therein intended to make up a deficiency in net revenues below a fair return through the "absorption" of an *alleged* excess in the Company's reserve account for depreciation.

This order of the Board effectively barred the Company from any possible relief in the way of increased service rates; it not only disallowed specifically the increases in rates proposed by the Company but disallowed *any increase* in rates whatever.

As the order prevented the Company from earning a fair return upon the fair value of its property devoted to the rendition of its service, it brought this suit on January 29, 1925, to enjoin the enforcement of such order on the ground that it would, if enforced, confiscate the property of the Company in violation of its rights under the Fourteenth Amendment to the Constitution of the United States, and on the further ground that it interfered unlawfully with interstate commerce.

The Bill and Supporting Affidavits.

The service furnished by the Company in the State of New Jersey is both intrastate and interstate and, therefore, in accordance with the established rule in suits of this character (*The Minnesota Rate Cases*, 230 U. S. 352, 435), the Company shows separately in its Bill and affidavits the value of its property employed in its intrastate business in New Jersey

and its earnings and expenses in connection with that business (Bill, R. 6-7; Affidavits, R. 85-89).

The Company's accounts are kept in accordance with the Accounting System and Regulations prescribed by the Interstate Commerce Commission which have also been adopted and approved by the appellant Board. As so kept the accounts do not separate the Company's property used in its service in New Jersey between intrastate and interstate business, nor do they separate the revenues and expenses relating to said classes of business (R. 84). An apportionment has, therefore, been made and is shown in the Bill and supporting affidavits. This apportionment (R. 94-103) is made by the same methods and on the same basis and by the same affiant as in the two suits of the Company which involved its intrastate property and business in the State of New York brought in the Southern District of New York in 1922 and 1924 (*Prendergast* v. *N. Y. Telephone Co.*, 262 U. S. 43; *N. Y. Telephone Co.* v. *Prendergast*, 300 Fed. 822).

The Bill in this suit also follows closely the form of the Bill in the New York suits of the Company above referred to. In the first of those suits the sufficiency of the Bill was attacked but was approved by this Court (262 U. S. at page 47).

However, the Company, in order that the Court might have before it a complete picture of all of its business in the State of New Jersey, did not stop at showing the figures relating to its intrastate property and business alone, but also set forth the figures relating to its entire business and property in that State, *both intrastate and interstate* (R. 7, 8, 90-94). These figures show that the Company's rate of net return on its purely intrastate business is much less than on its entire operations in New Jersey (R. 6, 7, 85-94). In other words, the interstate business is far more profitable than the intrastate business under the rates imposed upon the Company by the Board.

No separation of the purely intrastate business was presented in the proceedings had before the Board which resulted

in the order complained of, as it is neither customary nor necessary to do so in such a hearing which is held for the purpose of determining *just and reasonable* rates (R. 89).

The Bill alleges (R. 13-14), and the allegations are supported by the Company's affidavits (R. 88), that if the order of the Board was enforced, the Company would be prevented from earning any return in excess of the following percentages per annum upon the value or cost of its property used in its *intrastate* business and upon the value or cost of its entire property used in *both its intrastate and interstate* business:

	Return upon Value	Return upon Cost
Intrastate Property.....	0.40%	0.46%
Entire property, both intrastate and interstate.....	3.56%	4.12%

The Company alleges that it is entitled to an annual return of 8% upon the fair value of its property (R. 7). The Board concedes that the Company should have an annual return of at least 7½% upon fair value (R. 13).

The Bill further alleges (R. 8-13), and the allegations are supported by the moving affidavits, that the provisions of the order of the Board which fix the charges of the appellee for depreciation expense would, if enforced, confiscate the property of the Company (R. 124) and that such provisions are in conflict with the Interstate Commerce Act and the orders and regulations of the Interstate Commerce Commission and, therefore, invalid and beyond the powers of the Board (R. 135-139).

The Answers and Opposing Affidavits.

The Board, in its decision (R. 38, 39) found that for 1924 the service rates then in existence (and complained of in this suit) would fail to produce a fair return upon the value of the Company's entire property (interstate and intrastate) by $1,300,000. It found further, upon the

opinion of its engineer, that there was an excess of $4,750,000 in the Company's depreciation reserve due, as it claimed, to the inclusion in the expenses of past years of an excessive amount for depreciation expense. It sought to justify a continuance of the old service rates by requiring the Company to charge to depreciation expense after January 1, 1925, a sum less than the amount which the Board itself found was the proper annual depreciation expense to the extent necessary to wipe out the *admitted shortage* under a fair annual return. It also decided that the depreciation expense rates which the Company was charging were excessive and should be reduced materially in the future. In arriving at the rate base the Board fixed the value of the Company's entire property in New Jersey at $14,000,000 less than the sum which the Company's proof showed was a fair and reasonable value.

Its answering papers in the main seek to justify and support the Board's decision as to the treatment of the alleged excess in the depreciation reserve account. The question of the separate value of the Company's property devoted to the intrastate business and its revenues and expenses in connection with that business were not before the Board in its investigation. The answering affidavits, while they in some respects criticise the method adopted by the Company in separating its interstate and intrastate property and business, *fail to set up any figures for that property and business.*

Furthermore, the answering affidavits set forth an estimate of the return for the year 1925 under the enjoined service rates. This shows that, using the Board's own rates of depreciation expense, these enjoined service rates would produce on the *average cost* and on the *average fair value* of the entire property as fixed by the Board annual returns of only 5.4% and 4.93% respectively (R. 211).

The Opinion of the Court Below.

The motion was very fully argued in the Court below, two days being devoted to it (R. 1). The Court granted the motion (R. 238) primarily on the ground that the action of the Board in seeking to make up the admitted

deficit in annual earnings by attempting to absorb an *alleged* excess in the depreciation reserve account was unjustified. The Court also indicated that if the value of the Company's property devoted to intrastate service and its revenues and expenses connected therewith, should be alone considered, the return which the enjoined rates would produce manifestly would be confiscatory (R. 239). The order which was entered nearly two months after the motion was argued enjoined the enforcement of the order of the Board and required the Company to file a bond in the penal sum of $2,000,000 for the protection of its subscribers (R. 240).

Errors in the Appellants' Statement of the Case.

On page 4 of its brief the Board states: "There is no question here as to the fairness of the valuation of the appellee's property which was made by the Board nor of the adequacy of the rate of return, viz; 7.53 per cent. which the Board allowed, nor of the fact that there is a surplus exceeding $4,750,000 in the appellee's depreciation reserve." Such a statement is unjustified. On the contrary each of the questions or matters referred to in the above quotation from the Board's brief was disputed and put in issue by the Bill and moving papers (R. 6, 7, 13, 81-83, 113, 115, 127) and the evidence before the Court below in reference to them will be discussed under the points in this brief to which they relate.

The Company submits that the Court below was right upon the main ground referred to in its opinion and also that upon all the evidence before that Court it exercised properly its discretion in granting a preliminary injunction.

SUMMARY OF ARGUMENT.

POINT I.

The requirement of the Board that the Company overcome an admitted deficit in its annual earnings by revising retroactively the depreciation expense actually charged in the past is illegal and compliance with such requirement would confiscate the property of the Company.

Upon the face of the opinion of the Board (R. 38, 39) and its affidavits (R. 211) it appears that, using the Board's own property valuation and its computation of revenues and expenses, under the telephone rates required by the Board to be continued in force the Company would suffer a deficit of $1,300,000 in 1924 (R. 39) and $2,631,281 in 1925 (R. 211) below the annual return found by the Board to be fair.

In order to get rid of this shortage below a fair annual return the Board allows the Company as an annual depreciation expense a sum substantially less than the Board itself finds to be the actual, normal, currently accruing depreciation (see opinion of Court below, R. 238), until an alleged excess of $4,750,000 in its "depreciation reserve" shall have been "absorbed". The Company denies the existence of any such excess, or of any excess whatever, and such denial is supported by its affidavits (R. 127). Moreover, the present balance in this account was built up prior to the Board's order under service rates lawful at the time when charged and during a period when no depreciation expense rates had been prescribed by the appellants or their predecessors in office.

There is no justification in law or equity for any such treatment of the Company's past expenses.

Newton v. *Consolidated Gas Co.*, 258 U. S. 165, 175;
Galveston Electric Co. v. *Galveston*, 258 U. S. 388;
Knoxville v. *Knoxville Water Co.*, 212 U. S. 1;
Monroe Gaslight & Fuel Co. v. *Mich. P. U. C.*, 292 Fed. 139, 147;
Garden City v. *Garden City Telephone, Light & Mfg. Co.*, 236 Fed. 693.

POINT II.

The Company's charges for depreciation expense are regulated by the Interstate Commerce Commission and its jurisdiction is exclusive; the order of the Board is, therefore, invalid and its enforcement was properly enjoined.

The Company is a common carrier engaged in interstate commerce as defined and provided in the Interstate Commerce Act and is subject to the jurisdiction of the Interstate Commerce Commission. Its depreciation expense must be and has been determined in accordance with the orders of the Interstate Commerce Commission. Under the orders of that Commission the Company contends that it is compelled to charge its present rates of depreciation and that the jurisdiction of the Interstate Commerce Commission in that regard is exclusive.

POINT III.

Without regard to the questions argued in the foregoing points the preliminary injunction properly was granted upon all the evidence before the Court below.

1. The order of the Board if enforced would confiscate the property of the Company by reducing its value more than $14,000,000. The Board erred both in law and in fact in its findings as to the value of the property.

2. The Board did not meet the proof of the Company as to the cost and value of its *intrastate* property or as to the results of the operation of its *intrastate* business under the telephone rates enjoined.

3. The telephone rates enjoined did not produce and could not produce a fair return upon the value of the Company's property, nor even upon its cost. This is so whether the entire property and business be considered or the intrastate property and business alone. Under such circumstances the Company was entitled to interlocutory relief.

The Minnesota Rate Cases, 230 U. S. 352, at pp. 470-472;

Missouri Rate Cases, 230 U. S. 474, at pp. 507-508.

4. The order of the Board requires the Company to charge for depreciation expense an amount less than the actual expense of depreciation and hence if enforced would work continuing confiscation of the Company's property.

POINT IV.

There was no abuse of discretion by the Court below.

Prendergast v. *New York Telephone Co.*, 262 U. S. 43, 51-52;

Chicago Great Western Ry. Co. v. *Kendall*, 266 U. S. 94, 100.

ARGUMENT.

POINT I.

The requirement of the Board that the Company overcome an admitted deficit in its annual earnings by revising retroactively the depreciation expense actually charged in the past is illegal and compliance with such requirement would confiscate the property of the Company.

The character of the depreciation expense charges and the account for accrued depreciation.

At the outset of the argument of this point it would seem proper to explain this subject briefly as many of the statements in the Appellants' brief in reference to it are incorrect.

There is no "reserve" in the sense of a fund. The depreciation account, designated "Reserve for Accrued Depreciation" in the I. C. C. system of accounts for telephone companies, is a piece of accounting machinery by which the cost of plant used up in furnishing the service, less the net salvage recovered when it is retired from service, is charged to expense evenly over the life of the property in service. *The money represented by the balance in this account is invested in property to take the place of property retired.* The accounting is as follows:

When a unit of property goes into service it is irrevocably committed to the enterprise and becomes at once subjected to all causes that destroy such property and lead to its retirement. These causes are the ordinary action of the elements that result in rust, rot and decay; wear and tear; progress in the art that may lead to obsolescence or inadequacy; other inadequacy, such, for example, as results from the growth

and development of the community; public requirements, such, for example, as municipal ordinances requiring the abandonment of pole lines and the substitution of underground construction; storms, in particular sleet storms that are very destructive to overhead lines; and other casualties.

This using up of the property in furnishing telephone service is an expense of operation.

In the Company's accounting system (prescribed by the Interstate Commerce Commission, to whose jurisdiction the Company is subject, and approved by the appellant Board) this expense is based on the actual original cost of the property, less net salvage, so that the total of this expense on account of any unit of property is its original cost less the net salvage.

This expense is charged in the accounts at a rate per cent. of the actual cost, determined separately for each class of depreciable property in accordance with the estimated average service life and salvage of the units of each class. It is charged month by month, so as to spread it as evenly as may be over the life of the unit of property in service. Therefore, the charge to depreciation expense on account of any unit begins when it is put into service and continues until it goes out, based upon its expected life and salvage. These estimates are corrected, and the expense ratio modified, from time to time as experience and judgment indicate.

When the *charge* to expense is entered on the books a *credit* entry in the same amount is concurrently made in the account Reserve for Accrued Depreciation. When a unit of property goes out of service (no matter what the cause), *no charge to expense is made,* but its original cost less the net salvage is written out of the account Reserve for Accrued Depreciation. This is the *debit* entry. The charges to expense have already been made, month by month.

The balance appearing on the books of the Company in the account Reserve for Accrued Depreciation and referred to in the opinion of the Board (R. 49-50) is the balance from the credit and debit entries in that account. All future retirements of units of plant will be charged to that account.

In short, the accounting machinery is this:

> When property goes into the plant the cost of it goes into the capital accounts. While the property remains in the plant a per cent. of its cost, based on the service life, is charged monthly as an expense of operation, and the same amount goes into the account "Reserve for Accrued Depreciation." When the property is taken out of the plant, (1) no further expense is then charged, (2) the cost is taken out of the capital accounts, and (3) the cost is taken out of the account "Reserve for Accrued Depreciation."

The accounting rules on depreciation expense as prescribed by the accounting system are more fully described in the Company's affidavits (R. 131-143; Addition to Record, p. 9).

What the Company has done is this: Against the time when the property will be gone, the Company has taken a part of its operating earnings and bought other telephone property, of the same kind or other kinds. The Company has in this way protected its investment and its financial structure.

The property bought with the moneys credited to the depreciation account is in all respects the property of the Company and does not represent a contribution by the telephone rate payers.

In the opposing affidavits of the Board and also in its brief (p. 11) the idea is set forth that the credits to the depreciation account have been "contributed" to the Company by the rate payers. This idea has its root in the notion that the subscribers, instead of paying the Company for telephone service, pay an amount for wages and salaries, another amount for taxes, for depreciation expense, for interest, for dividends, etc. Such an idea is incorrect and unwarranted (Addition to Record, p. 10).

There are no tagged dollars. The so-called reserve is a mere matter of book-keeping. No separate allowance or rate

has been paid to the Company by its subscribers for depreciation or any other item of expense. All the operating revenues go into the treasury of the Company. The fact is that the Company sold its service for a price regulated by the State, subject to constitutional limitations. The service belonged to the subscribers because they paid for it and the money was the Company's because the Company earned it. The money has been invested in telephone property, and this property bought by the Company with the money it earned is the Company's property.

The Board's finding of an alleged excess in the depreciation account is untrue in fact.

In its opinion (R. 49-50) the Board found that there was an excess in this account at the end of the year 1924 of over $4,750,000. This finding rests solely upon the *opinion* of its engineering expert Mr. Hill, a young man who has had no practical experience in financial or operating management of telephone properties (R. 187). The excess found by the Board is an excess above what its said engineer terms "present requirements." He makes his estimate of present requirements by carrying back his estimated present depreciation rates into the past years and consequently his finding of an excess is bound up with the accuracy of his estimate of present annual depreciation rates and rests upon the same factors; namely, the average life and salvage as *estimated* by him.

Even were his estimated depreciation expense rates correct for the future it does not follow that they were right for the past.

The Company strongly denies the existence of any such excess as found by the Board, or of any excess whatever, in its depreciation account and the unsoundness of the Board's findings is shown in detail in the Company's affidavits (R. 117-129).

As to the fact of an excess, if it were material, a direct issue would be presented that could only be determined after a trial.

The improper use by the Board of an alleged excess in the depreciation account to overcome the shortage in annual earnings under a fair return is shown by its opinion and the computations therein.

The order and opinion of the Board are set forth in full as Exhibit A to the Bill (R. 16-70). The average value of the entire property in New Jersey (intrastate and interstate) for the year 1924 is found by the Board to be $76,370,000 (R. 32). On this value the Board finds that the Company is entitled to an annual return of from $5,750,000 to $6,000,000 (R. 36). This is at a rate of approximately 7½%. The Board then states its findings as to the Company's entire operations in New Jersey under the enjoined rates for the year 1924 as follows (R. 38):

"Results under Present Rates—Estimated for the Year 1924

	By Company (Exhibit P-14)	By Board, based on Exhibit C-34 modified
Revenues:		
Exchange Revenues	$11,936,000	$11,936,000
Toll Revenues	10,465,000	10,465,000
Miscellaneous Operating	257,000	257,000
Total Telephone Revenue	$22,658,000	$22,658,000
Expenses:		
Traffic Expenses	$5,846,000	$5,846,000
Commercial Expenses	2,309,000	2,309,000
General and Miscellaneous Expenses	548,000	548,000
Uncollectible Operating Revenues	150,000	150,000
Rent and Other Deductions (1)	283,000	283,000
Current Maintenance (1)	3,230,000	3,230,000
Depreciation	*3,452,000*	*2,678,000*
Taxes	2,170,000	2,200,000
Licensee Revenue, Dr.	965,000	965,000
Total Telephone Expenses	$18,953,000	$18,209,000
Total Telephone Earnings	$3,705,000	$4,449,000

(1) Include a certain portion of depreciation for right of way from clearing accounts.

(2) Omits concessions ($102,000) and interest during construction ($160,727) aggregating $262,727 in Exhibit C-34" (italics ours).

As stated at the heading of the above table the figures used were estimates, as they were considered by the Board before the complete results of the operations in 1924 were known. The actual results for that year are stated in the Company's affidavits (R. 92) and show that the net earnings of the Company were about $300,000 less than the estimate in the above table.

If the Court will examine this table of figures it will see that the Board sets up two parallel columns, *both under the telephone rates enjoined,* one showing the figures of the Company, and the other those figures as modified by the Board. From a comparison of the two columns it will be noted that the revenues stated by the Board are exactly the same as the Company's figures. The expenses used by the Board are also identical with those of the Company except in two particulars; namely, the depreciation and the taxes. The change in taxes results from the adjustment of expense in connection with depreciation which, by making an addition to the net revenue, increases the income taxes accordingly. The real difference between the two columns results from the handling of one expense item, namely, depreciation, which, in the modified figures adopted by the Board is reduced by the amount of $774,000 for the year 1924. The arbitrary reduction of this actual expense item is one of the errors complained of by the Company and will be discussed in a later point of this brief.

The Board then points out (R. 39) that even after making the arbitrary reduction in the depreciation expense item just mentioned the net revenues are short of the fair return allowed by the Board itself by an amount approximately $1,300,000. This conceded shortage plus the depreciation expense item of $774,000 above referred to makes the total shortage in the operations of the year 1924 on the Board's computation, $2,074,000. [It is of interest to note here that the proposed rates which the Board refused to approve would have increased the Company's revenues by only $2,300,000 annually (R. 144)].

In order to get rid of this *admitted deficit* in the Company's earnings the Board resorts to an unlawful and retroactive revision of the Company's depreciation expense which has been actually charged in the past. Specifically, the method employed to accomplish this is by directing that future charges to depreciation expense be reduced below the amount which the Board itself thinks proper to the extent necessary to make up the admitted deficit in annual earnings and that this be continued until such time as the sum of $4,750,000, *alleged* by the Board to be an accumulated excess in the depreciation reserve, shall have been absorbed (Bill, R. 13; R. 39).

The Board in its decision then says (R. 39):

> "In the opinion of the Board, the company should, beginning January 1st, 1925, compute the total normal charges to depreciation expense by use of the annual depreciation rates as hereinafter provided. From the amount so computed it should deduct an amount sufficient to allow the net telephone earnings for a given period (month or year) to equal a fair return on the value of its property in service as herein found by the Board. These deductions should be made until their total is equal to $4,750,000 herein found as the minimum amount which has heretofore been charged to depreciation expenses over and above the amount which will be found as a credit in the depreciation reserve to be set up on January 1st, 1925 as herein provided.
>
> "The result of this procedure will be that it will not be necessary for the company to collect as much from the rate payer for depreciation expense *as it would have to charge if this excess balance in the depreciation reserve did not exist* and will make it possible for the company to earn a fair return on the value herein fixed without resorting to an increase in its rates at this time." (Italics ours.)

Previously in its decision the Board had said (R. 20):

> "While it appears that no increase in rates is found to be justified at this time for reasons hereinafter indicated" (*i. e.*, the alleged excessive balance in the depreciation reserve) "it is apparent that *when the excess in the depreciation reserve has been absorbed the rates may have to be readjusted.*" (Italics ours.)

The parts of the Board's order and decision discussed above had reference to the operations of 1924 under the enjoined rates—the results of operations for 1925 as estimated by it are shown in its opposing affidavits and make even clearer the illegality of the Board's action.

In its opposing affidavits the Board gives its estimate of the Company's operations during the year 1925 under the enjoined telephone rates, *computing depreciation expense at its own rates* and using its own valuation of the property as the base to which to apply the rate per cent. of annual return. This estimate of the Board is as follows (R. 211):

"ESTIMATED RATE OF RETURN
DURING YEAR 1925
UNDER PRESENT RATE SCHEDULE.

	Plaintiff's Depreciation Rate	Board's Depreciation Rate	Compliance with Order of Board
Telephone Revenues:			
Exchange Service.....	$13,281,000	$13,281,000	$13,281,000
Toll Service.....	11,113,000	11,113,000	11,113,000
Miscellaneous	316,269	316,269	316,269
Total Telephone Revenues.	$24,710,269	$24,710,269	$24,710,269
Telephone Expense:			
Current Maintenance.....	$ 3,453,400	$ 3,453,400	$ 3,453,400
Depreciation and Amortization	*4,128,000*	*3,311,716*	*688,430*
Traffic	6,404,465	6,404,465	6,404,465
Commercial	2,657,000	2,657,000	2,657,000
General and Miscellaneous..	589,166	589,166	589,166
Uncollectibles	140,000	140,000	140,000
Taxes	2,269,691	2,371,812	2,700,723
Rent Expense and Deductions	325,744	325,744	325,744
Miscellaneous Deductions...	56,813	56,813	56,813
License Contract Expense..	1,041,695	1,041,695	1,041,695
Total Telephone Expense.	$21,065,974	$20,354,811	$18,052,436
Net Telephone Earnings..	$ 3,644,295	$ 4,355,438	$ 6,657,833
Average Cost... $86,401,736			
% Return on Avg. Cost	4.22	5.04	7.71
Defendant's Average Fair and Reasonable Value 88,417,448			
% Return on Value	4.12	4.93	7.53"

(italics ours)

* NOTE.—The differences in the tax estimates are due to the reduction of the depreciation expense and consequent increase of net earnings.

The above table shows that, *using the Board's own depreciation expense rates,* the Board computes the necessary and proper depreciation expense for 1925 at $3,314,716, but further shows that if the whole amount of such expense is charged in that year the Company can earn an annual return of only 4.93% on the value of its property as found by the Board. In order, therefore, that the Company may appear to earn a rate of return which the Board itself states to be fair, namely, 7.53%, it would compel the Company through compliance with its order to charge to depreciation expense only $683,430 of this $3,314,716 and, in effect, transfer the difference of $2,631,286 from expense to earnings, thus "dipping into" the existing depreciation reserve for that amount.

The above table also shows that if the depreciation expense rates which the Company insists are correct are used in making the calculation, the Company would be able to earn only 4.12% on the property value found by the Board; the Company's estimate of depreciation expense being $813,284 greater than the amount of such expense which results from the use of the Board's depreciation rates. *This makes the total shortage for the year 1925 below a return of 7.53% on the Board's rate base, $3,444,570* ($2,631,286 plus $813,284).

Further, the court should bear in mind that the Board's average property value for 1925 of $88,417,448 (R. 211) is nearly $14,000,000 less than the fair and reasonable value of the property for this year as shown and claimed by the Company in its affidavits (R. 93; Point III *infra*), and that the shortage above stated would be increased if the return were computed upon the actual fair value.

The per cent. return on the intrastate property and business alone is less than on the entire property and business.

The figures given by the Board in the above tables of figures have reference to the entire property, revenues and expenses of the Company in the State of New Jersey used in *both* intrastate and interstate service. If these figures be

apportioned to intrastate and interstate service respectively, *no matter on what basis*, it is obvious that the percentages of net return would be much smaller upon the *intrastate* property and business when considered alone, as it is not disputed that the interstate business is more profitable than the intrastate business (R. 6, 7, 85-93).

The Company cannot be punished in the manner attempted by the Board for its lawful operations in the past.

The Company contends that there is no justification in law or equity for the treatment of its past expenses which has been attempted by the Board.

Even were there in fact some excess in the reserve account for depreciation (*which there is not*), the Company cannot be penalized for its operations in the past under telephone rates that were lawful at the time *and during a period when no depreciation expense rates had been prescribed by the appellants or their predecessors in office.* The Board did not attempt to fix the depreciation expense rates of the Company until it made the order complained of in this suit and the depreciation expense rates thereby prescribed did not become effective until January 1, 1925, *and were for the future* (R. 16-17).

There is no punitive quality in rate making or rate regulation, and the Board cannot do indirectly what it cannot do directly. Whatever may have been accumulated in the past under telephone rates and practices then lawful is the property of the Company and entitled to constitutional protection. As the Court below said, "it is essential to remember that the property upon the value of which the plaintiff is entitled to a non-confiscatory return is the property (*not part of it*) that is being used in the service as of the time the inquiry regarding the rates is made" (R. 238-239). (Italics ours.)

Newton v. *Consolidated Gas Co.*, 258 U. S. 165, 175;
Knoxville v. *Knoxville Water Co.*, 212 U. S. 1;
Galveston Electric Co. v. *Galveston*, 258 U. S. 388;

Monroe Gaslight & Fuel Co. v. *Mich P. U. Com.*, 292 Fed. 139;

Garden City v. *Garden City Telephone, Light & Mfg. Co.*, 236 Fed. 693.

In *Newton* v. *Consolidated Gas Co., supra,* this Court said at page 175:

> "Since 1907 the Gas Company has been subject to supervision by a Commission empowered to prohibit unreasonable rates and the presumption is that any profits from its business were lawfully acquired. *Municipal Gas Co.* v. *Public Service Commission,* 225 N. Y., 89, 99, 121 N. E. 772. Mere past success could not support a demand that it continue to operate indefinitely at a loss. The public has no such right in respect of private property although dedicated to public use. When it became clear that the prescribed rate had yielded no fair return for more than a year and that this condition would almost certainly continue for many months the Company was clearly entitled to relief."

In *Monroe Gaslight & Fuel Co.* v. *Michigan P. U. Commission, supra,* the statutory court (Denison, *C. J.*, and Tuttle and Simons, *D. JJ.*) said, in speaking of the depreciation reserve of the plaintiff in that suit:

> "The existence of such a surplus on the books has little evidential force. It means only that at the rates which have been charged, the company has collected that amount in addition to what now appears to be the true amount of depreciation plus the amount which it has seen fit to pay out in fixed charges and dividends, or carry as surplus and undivided profits. The idea that such a depreciation account or retirement reserve, which grew up through the collection of lawful rates, is some sort of a trust fund in which the rate payers are interested and upon which the Utility has no right to earn a return, which idea has found favor with some Commissions (although the Michigan Commission has not indicated its adherence thereto) is without foundation. The fact that such excess, along with what is called surplus or undivided profits, has been invested in further

> property, does not deprive the Utility of its full right to earn a return thereon. Past high profits, under a contract or under public supervision, form no obstacle to enjoining a later noncompensatory rate (the Consolidated Gas Case); and it can make no difference whether they have been paid out in dividends and reinvested as additional capital, or have been directly reinvested" (p. 147).

In *Garden City* v. *Garden City Telephone, Light & Mfg. Co.*, 236 Fed. 693 (Circuit Court of Appeals, 8th Circuit), the head note reads:

> "In determining the validity of an ordinance fixing rates to be charged by an electric company, claimed to be unconstitutional as confiscatory, the capital on which the company is entitled to a fair return is the reasonable value at the time of the property being used in the service, and it is immaterial that such property was in part acquired or paid for out of previous earnings of the business, or whether or not previous rates were reasonable or excessive."

It is interesting to note that the Board, in its order, recognizes this rule of law in so far as the rates for telephone service are concerned, and invokes it against the claim of the Company that it was not able to earn a fair return under the enjoined rates during the years 1921 to 1924, both inclusive. See the Board's opinion where it says (R. 52):

> "Where a utility neglects to apply for an increase in rates to which it is entitled the fault is its own. (*Knoxville* v. *Knoxville Water Co.*, 212 U. S. 1; *Galveston Electric Co.* v. *Galveston*, 258 U. S. 388)."

What the Board fails to recognize and point out is that the *Knoxville* case holds the same rule applicable to the depreciation charges. After saying in that case (p. 13) that a water plant begins to depreciate in value from the moment of its use and that, before coming to the question of profit at all, the Company is entitled to earn a sufficient sum annually to make good the depreciation and replace parts of

the property when they come to the end of their useful life, thereby making provision out of earnings for the replacement of the property; and after further pointing out that it is not only the right of the Company to make such provision but its duty, both to the investors and the public, this Court says at page 14:

> "*If, however, the company fails to perform this plain duty and to exact sufficient returns to keep the investment unimpaired, whether this is the result of unwarranted dividends upon over-issues of securities, or of omission to exact proper prices for the output, the fault is its own.* When, therefore, a public regulation of its prices comes under question, the true value of the property then employed for the purpose of earning a return cannot be enhanced by a consideration of the errors in management which have been committed in the past." (Italics ours.)

In other words, if in the instant case the depreciation balance were less than adequate, for whatever reason, the Company would not be permitted to charge telephone rates for the future sufficiently high to enable it to make up this deficiency out of its future earnings. It would be allowed rates that were currently adequate and no more and if it desired to replenish its depreciation account it would be obliged to do so out of its surplus or at the expense of its stockholders in the form of reduced dividends. We concede that such is the law. *But the rule must work both ways.* If the Company did now have, in fact, an excess in its depreciation account (*which it has not*), it is an amount that was charged against its revenues derived from lawful telephone rates and was lawfully reserved.

The case in this Court of *Louisiana Railroad Commission* v. *Cumberland Tel. Co.*, 212 U. S. 414, is cited by the appellants in their brief but is not in point. There was there no attempt, as here, to absorb an alleged excess in the existing depreciation balance to make up an admitted shortage in annual earnings. In that case the Court had before it no question of valuation of the property of the company, as the com-

pany claimed only a fair return on the amount of its capital stock outstanding. The Court's decision is only to the effect that the burden of proof was on the company to show that no part of the depreciation balance had been diverted from this account to create a part of its capital stock. Prior to the decision in the *Cumberland* case and before the accounting rules were adopted, some companies had declared stock dividends out of "depreciation reserve". The opinion recognized the impropriety of any diversion of the accumulated reserve account, and with that the practice of the Company and the accounting rules of the Interstate Commerce Commission are in strict accord.

It may be worth while to point out that the *Knoxville* case reported in the same volume (212 U. S. 1) and the *Cumberland* case were both decided in the year 1909, before the Interstate Commerce Commission took jurisdiction over telephone companies and before the accounting rules were adopted. In the *Knoxville* case, this Court had made an important pronouncement on the subject of depreciation. The accounting rules of the Interstate Commerce Commission, adopted soon after the *Knoxville* and *Cumberland* decisions, established the accounting principles to be followed and prohibit any such practice as is condemned by the opinion in the *Cumberland* case. The rules of the Interstate Commerce Commission have carried out the principles of both the *Knoxville* and *Cumberland* decisions.

A similar proposed treatment by a state Commission of an alleged excess in the depreciation account of the Company was before this Court in Prendergast v. *New York Telephone Co., 262 U. S. 43.*

In 1922 the Company secured an injunction from the District Court for the Southern District of New York against the Public Service Commission of New York to restrain a reduction in rates ordered by that Commission. In justification of the attempted reduction the Commission presented to the court affidavits upon which it was argued that the depre-

ciation expense of the Company had been too large in the past and that the balance in the reserve account was excessive and should be reduced. One affidavit was made by Mr. James G. Wray who is acting as an expert for the Board in this suit. Mr. Wray there, as in this case, estimated a composite rate of depreciation arrived at by applying his revised schedule of depreciation rates to the various classifications of the Company's property and alleged that an excessive reserve had been built up. He then stated that,

> "because the Company has already accumulated a reserve for New York City of $14,000,000 more than is required, the annual allowance for depreciation should be not 4.56% but 3.94% in order that during a long period of years the amount in the depreciation reserve may be gradually brought back to normal; that the charges for depreciation made by the Company in 1921 for the property in New York City are at least $2,000,000 in excess of normal requirements, and that the expenses can be reduced by at least this amount. * * * If no charges for depreciation should be made in the expenses until such time as the Company's depreciation reserve has been brought down to normal proportions, the expenses for the year 1921, as claimed by Mr. Wiley in his affidavit, will be reduced by $10,465,722, and the net telephone revenue increased by the same amount, thus increasing to 8.09% the percent net annual revenue computed on the Company's basis. *It is estimated that by eliminating altogether for a period of two or three years the charges for depreciation, the depreciation reserve can be brought down to a normal basis.*" (Italics ours.)

In addition to Mr. Wray's affidavit the Commission introduced an affidavit made by Milo R. Maltbie substantially to the effect that the Company should make up shortages in its telephone earnings by not making charges to depreciation expense until the alleged excess in the depreciation balance had been absorbed.

The contention of the defendants in that suit is exactly in line with the action taken by the Board here. The question was argued fully in the New York suit before the stat-

utory court (Judges Hough, Knox and A. N. Hand) both orally and on the briefs, and was decided against the Commission. The Court said:

> "Plaintiff has for years charged as expense against gross revenue certain sums to 'Depreciation and Amortization.' By so doing a fund has been created for replacements or permanent repairs. For some years past the average depreciation rate for various kinds of equipment or property has not varied much from 5.80%. But not all repairs and replacements are made at once; *i. e.*, if a certain amount of depreciation is charged to Expense in the year 1921, it does not follow that all of such charge is expended in that year. Consequently there arises a 'Reserve for accrued depreciation,' or, what may be called,—a balance of unexpended depreciation reserve. *This balance now held by plaintiff has reached a much larger sum than the Public Service Commission thinks should exist.* Therefore it is asserted, in justification of the orders complained of that plaintiff should lower its rate of depreciation so as to set aside for (say) the year 1922, $3,000,000, less than did the rate of 1921 and preceding years. *This bookkeeping measure would of course increase net income by the sum just stated.*" (Italics ours.)

The Court rejected this contention and then further said:

> "It is now, however, not denied that the depreciation charges producing the present accumulations, *were lawful when made and as made*, and as such they have passed into the general mass of defendant's property." (Italics ours.) (*New York Tel. Co.* v. *Prendergast*, U. S. Dist. Ct. S. D. N. Y., In Equity, No. 23-252, not reported officially).

The Commission took an appeal to this Court and the question was here again argued both orally and on the briefs. This Court, without discussing the point in its opinion, affirmed the order of the trial court. (262 U. S. 43.)

[The references to the affidavits of Messrs. Wray and Maltbie will be found at pages 127 to 141, and the quotations from the opinion of the statutory court at pages 183 and 184

of the Transcript of Record before this Court in that suit. The argument of the City of New York will be found at pages 24-27 of its brief, and the argument of the Commission and the Attorney General at pages 39-42 of the joint brief filed on their behalf.]

The Board's treatment of the alleged balance in the depreciation account would, if enforced, require the Company indirectly to make charges against it not permitted by the Uniform System of Accounts prescribed by the Interstate Commerce Commission.

In order to comply with the Board's order the Company would have to divert and use its depreciation expense for the purpose of *artificially* creating net earnings sufficient to make up any shortage under a fair return upon the value of its property which the enjoined telephone rates failed to earn (Bill, R. 13; Affidavits, R. 138). The Board proposes by this process to absorb such part of what it states to be the *proper* annual expense of depreciation to the extent necessary to make the annual net return of the Company equal to 7½%.

This treatment of the balance in the reserve account for depreciation would be in direct violation of the Uniform System of Accounts prescribed by the Interstate Commerce Commission. Under that System of Accounts the only charges that can be made against this account are for property retired from the plant at the time such property is actually removed from service. (R. 131-139.) The amount so charged is the original cost of the property less any salvage realized. The order of the Board would compel the Company to charge to the account any deficiency in earnings in any year below the amount of earnings found by the Board to be fair, such charges to continue until in that way the sum of $4,750,000 (the alleged excess in the account) shall have been absorbed. It is true that the Board does not accomplish this by requiring the deficiency of earn-

ings to be entered directly upon the books as a charge against the depreciation reserve account, but instead treats it as a current reduction in the amount to be credited to it. However, it is manifest that the net result is as we have stated, namely, to write out of the account $4,750,000 that is now in it (R. 134-138).

POINT II.

The Company's charges for depreciation expense are regulated by the Interstate Commerce Commission and its jurisdiction is exclusive; the order of the Board is, therefore, invalid and its enforcement was properly enjoined.

The court below did not, in its opinion, pass upon this question. Since, however, this is a wholly independent and separate ground which, if our views of the law are correct, is decisive of the case and would lead necessarily to an affirmance without regard to any other question, we renew the point here.

The Company pleaded the point by appropriate averments in its bill of complaint, Sections XVI to XXIII, both inclusive. These averments show that the whole matter of depreciation charges and accounting has been committed by Congress to the Interstate Commerce Commission, which has regulated the subject comprehensively ever since January 1, 1913, and that the Board is without authority in the premises and its order constitutes an unlawful interference with interstate commerce (R. 8-13).

It is clear, beyond dispute, that the telephone rates required by the Board's order cannot stand if the provisions of the order respecting depreciation are void.

The Board takes the whole matter of depreciation expense accounting out of the hands of the management, and

the regulation of it out of the hands of the Interstate Commerce Commission. It assumes to fix the annual expense rate for each class of property to the exact one-hundredth of one per cent. (Board's finding No. 4-*c*, R. 60-1). Then, moreover, it does not permit the Company to charge even these inadequate rates, but orders the Company to reduce the charges by whatever amount the earnings fall short of a fair return (as determined by the Board). This is to be continued until the alleged excess of $4,750,000 is absorbed. The order provides:

> "When the total deductions from the normally required depreciation expense shall have aggregated a total of $4,750,000 such deductions shall be no longer made" (R. 61).

The Board exercised an authority it did not have (1) when it reduced the Company's depreciation rates, and (2) when it further reduced the charges to make up the admitted deficiency in earnings. By fixing telephone rates on this basis it deprived the Company of a bare fair return in the amount of $2,074,000 for the year 1924 ($1,300,000+ $774,000), and $3,444,570 for the year 1925 ($2,631,286+ $813,284), upon its own figures (see *supra*, pp. 17 and 21).

If the Company kept its books in compliance with this order they would show earnings for 1924 and 1925 in excess of the amounts actually earned by the sums stated.

The Company cannot comply with any of these provisions without violating the orders of the Interstate Commerce Commission and laying itself liable to drastic penalties.

Exclusive Jurisdiction of Interstate Commerce Commission.

Section 1 of the Interstate Commerce Act, as amended, provides "That the provisions of this Act shall apply to common carriers engaged in * * * the transmission of intelligence by wire or wireless; * * * from one state * * * to any other state" etc. It provides further that "the term 'common carrier' as used in this Act shall include * * * telegraph, telephone and cable companies operating

by wire or wireless." The Act further defines the term "transmission" as including all instrumentalities and facilities employed therein (41 U. S. Stat. L. 456, 474).

This Company is such a common carrier. It affords to its patrons and at all its telephones connections not only with all other telephones in its own system in the States of New Jersey, New York and Connecticut, but also connections with the telephones of other companies throughout the United States. In other words, its entire system is available to its patrons simultaneously at all times for both intrastate and interstate communications, and is being used continuously for both classes of communications. In that respect, its plant is similar to that of a large railroad system. The same telephones, wires, switchboards, buildings, etc., are used for both classes of transmission, just as a railroad employs the same right-of-way, ties, rails, rolling stock and buildings for hauling freight and passengers in both classes of transportation.

There can be only one correct rate of depreciation applicable to any class of property. Because the whole property is devoted to interstate commerce (although being also devoted to intrastate commerce) the federal power to regulate interstate commerce attaches to the whole property, and that power has been and is being exercised.

The Interstate Commerce Commission, by an order entered December 10, 1912, effective January 1, 1913, adopted and promulgated the "Uniform System of Accounts for Telephone Companies" (Class A and B) (R. 139).

That order has remained in effect ever since, and since January 1, 1913, the Company has kept, and now keeps, its accounts in accordance with it.

The Uniform System of Accounts for Class A and B Telephone Companies, together with the interpretations and rulings made by the Interstate Commission since it was prescribed in 1912, includes a complete and comprehensive regulation of the subject of depreciation accounting.

Account No. 608, "Depreciation of Plant and Equipment", an operating expense account, Account No. 340, "Amortization of Landed Capital", and Account No. 102, "Reserve for Accrued Depreciation", are created. Regulations covering entries to be made in connection with fixed capital withdrawn or retired are set forth. Under the heading "Instructions Pertaining to Operating Expense Accounts," the explanatory text deals in detail with the subject. Extraordinary repairs, as distinguished from ordinary repairs, are defined and their treatment in relation to depreciation accounting covered. The elements that comprise expense of depreciation are enumerated. *The accounting company is directed to base its depreciation charges upon rules to be determined by itself, but these rules must be derived from a consideration of the company's history and experience, and it is provided that the company must be prepared at all times to justify the charges made for depreciation by furnishing to the commission upon demand a sworn statement of the facts, expert opinions, and estimates upon which they are based.* These charges are not to be made in lump sums but are to be spread over a period which is defined. Various appropriate accounts are prescribed and designated by number and name.

We do not deem it desirable to burden this brief with a reprint of the provisions above referred to, but we wish to direct special attention to the full text of Section 23 which appears in the record, page 140.

The provisions may be summarized as follows. At all times since January 1, 1913:

(1) Depreciation has been authoritatively defined by the Interstate Commerce Commission to include the using up of property in service ("capital consumed in operations")

from all causes whatever—wear and tear not covered by current repairs, obsolescence, inadequacy, public requirements, and extraordinary casualties (R. 140).

(2) The property so used up is an expense of operation, and its cost less salvage measures the amount of this expense (R. 140).

(3) This expense is to be charged by the company from month to month at rates per cent. based upon the average service lives and salvage of the respective classes of the depreciable property, thus to distribute the expense evenly throughout the service life of the property (R. 140).

(4) The Company has been required by law to determine its current charges for depreciation expense by rules derived *by the Company* from a consideration of its own history and experience, *and to stand ready at all times to justify the charges as made and reported to the Interstate Commerce Commission by the sworn statements of the facts, expert opinions and estimates upon which they have been based* (R. 140).

We digress at this point in our statement of the facts regarding federal regulation to point out how impossible it is to reconcile what the Board has done by its order with these requirements of the Interstate Commerce Commission. The Board takes the matter out of the hands of the Company and out of the hands of the Interstate Commerce Commission and fixes the rates of depreciation expense, and requires the Company to make the entries upon its books in accordance with its order, under the pain of penalties provided in the statutes of New Jersey for a violation of an order of the Utility Board.

The Company shows that it cannot justify those rates and that if it should charge and report them to the Interstate Commerce Commission, and should be called upon by that Commission to support them upon "a sworn statement of the facts, expert opinions, and estimates upon

which they are based" it would be unable to do so, and would be obliged to make oath that they are wrong and entirely insufficient (R. 123).

It is equally clear that it cannot comply, and should be protected by injunction from being forced to comply, with the other provisions of the order dealing with the same subject, particularly the provision that in effect requires the Company to charge operating deficits against the book account for depreciation, to the extent of $4,750,000. The orders of the Interstate Commission do not permit this to be done. The Uniform System of Accounts definitely provides what shall constitute proper charges against the depreciation account and nothing else can be charged against it. This is shown in the affidavit of Andrew Sangster on Depreciation Accounting, where the provisions of the accounting system are set forth under Account 102 "Reserve for Accrued Depreciation", the second paragraph of which deals with charges to this account (R. 138). The substance of that paragraph, stated in nontechnical language, is that there shall be charged against the account the cost of property retired at the time of its retirement. No other charge is permitted.

Returning from this digression, Congress amended the Interstate Commerce Act by an amendment (41 U. S. Stat. L. 456; 493) to Paragraph 5 of Section 20, approved February 28, 1920, effective on that date, so that it now reads as follows, the amendment being the part in italics:

> "Interstate Commerce Act
> Paragraph (5) of Sect. 20.
>
> "The Commission may, in its discretion, prescribe the forms of any and all accounts, records, and memoranda to be kept by carriers subject to the provisions of this Act, including the accounts, records and memoranda of the movement of traffic, as well as of the receipts and expenditures of moneys. *The Commission shall, as soon as practicable, prescribe, for carriers subject to this Act, the classes of property for which depreciation charges may properly be included under operating expenses, and the percentages of depreciation which shall*

be charged with respect to each of such classes of property, classifying the carriers as it may deem proper for this purpose. The Commission may, when it deems necessary, modify the classes and percentages so prescribed. The carriers subject to this Act shall not charge to operating expenses any depreciation charges on classes of property other than those prescribed by the Commission, or charge with respect to any class of property a percentage of depreciation other than that prescribed therefor by the Commission. No such carrier shall in any case include in any form under its operating or other expenses any depreciation or other charge or expenditure included elsewhere as a depreciation charge or otherwise under its operating or other expenses. * * *, and it shall be unlawful for such carriers to keep any other accounts, records or memoranda than those prescribed or approved by the Commission, * * *."

It will be observed that the amendment directs the Interstate Commerce Commission, as soon as practicable, to prescribe the depreciation expense rates to be charged. It is our view that the significance of this amendment lies only in the *mandate* to the Interstate Commerce Commission, that is, in the *direction* to fix the rates. Whether we are right or wrong about that would not change the result in this case.

After this amendment was passed the first significant action taken by the Interstate Commerce Commission was to issue on March 18, 1920, and serve upon the carriers, including this plaintiff, the following order (R. 142):

"INTERSTATE COMMERCE COMMISSION
Washington

MARCH 18, 1920.

"To All Carriers Concerned:

"Section 435 of the Transportation Act, 1920, contains the following provision:

'The Commission shall, as soon as practicable, prescribe, for carriers subject to this Act, the classes of property for which depreciation charges may properly be included under operating expenses, and the percent-

ages of depreciation which shall be charged with respect to each such classes of property, classifying the carriers as it may deem proper for this purpose. The Commission may, when it deems necessary, modify the classes and percentages so prescribed. The carriers subject to this Act shall not charge to operating expenses any depreciation charges on classes of property other than those prescribed by the Commission, or charge with respect to any class of property a percentage of depreciation other than that prescribed therefor by the Commission. No such carrier shall in any case include in any form under its operating or other expenses any depreciation or other charge or expenditure included elsewhere as a depreciation charge or otherwise under its operating or other expenses.'

"Information received by the Commission indicates the existence of doubt as to the propriety of carriers making any charges to operating expenses with respect to depreciation prior to such time as the Commission shall prescribe the specific percentage of depreciation which shall be charged.

"The purpose of this circular is to dispel any such doubts as may exist in the minds of accounting officers.

"Until the Commission shall otherwise order, all carriers subject to the Act to regulate commerce should continue to observe the requirements respecting the accounting for depreciation which are embodied in the effective accounting classification prescribed by the Commission for the respective classes of carriers.

GEORGE B. MCGINTY,
Secretary."

The gist of this order is to direct the companies to continue to comply with the Uniform System of Accounts until the further order of the Commission.

No further order has as yet been made, but the Interstate Commerce Commission has been engaged diligently in carrying out the mandate of the amendment. Divers and extended investigations have been conducted, and several hearings have been held to that end, as shown by our bill of complaint, Paragraph XVII (R. 11). The Company is awaiting the further action of the Commission.

That in this situation the Company cannot comply with the provisions of the Board's order, that such order is void for want of jurisdiction over the subject matter, and is an unlawful interference with interstate commerce, and that the Company is entitled to the injunctive protection which it seeks, seems to us to be entirely clear.

Any possible doubt there might have been as to the authority of the Interstate Commerce Commission to make and enforce such regulations as these was set at rest by this Court in *Interstate Commerce Commission* v. *Goodrich Transit Company*, 224 U. S. 194, decided April 1, 1912, a few months, it will be noted, before the Interstate Commerce Commission prescribed the Uniform System of Accounts for Telephone Companies. That case pertinently calls attention to the other powers and duties of the Interstate Commerce Commission and to the requirement of annual reports and other reports by the carriers and, in that connection, points out the necessity for uniformity in the accounts. Manifestly, if depreciation may be accounted for on one basis laid down by one state commission and different and varying bases laid down by other state commissions, the statements of the carriers' financial condition shown in their reports to the Interstate Commerce Commission will mean nothing.

This practical construction of the Interstate Commerce Act has not been seriously questioned, so far as we know, and the jurisdiction of the Interstate Commerce Commission over these matters has been uniformly acquiesced in by state commissions throughout the country, including the New Jersey Board.

The rule that the long continued practical construction of an Act of Congress by a department of the Government, long acquiesced in by one now complaining, will be usually decisive as to the correct construction, is familiar law. That this principle applies to a construction placed by the Interstate Commerce Commission upon provisions of

the Interstate Commerce Act (as well as to that of executive and administrative departments) is settled by *New York, New Haven and Hartford Railroad Co.* v. *Interstate Commerce Commission*, 200 U. S. 361. Other cases are the following:

United States v. *Cerecedo Hermanos y Compania*, 209 U. S. 337;
United States v. *G. Falk & Bro.*, 204 U. S. 143;
United States v. *Philbrick*, 120 U. S. 52;
National Lead Co. v. *United States*, 252 U. S. 140;
Postal-Telegraph Cable Co. v. *Warren Godwin Co.*, 251 U. S. 27.

The controlling principles are familiar; that where the Federal power enters it dominates; there can be no conflict of jurisdiction; the fact that the exercise of the Federal power operates upon intrastate facilities and business of the carriers is no objection to its exercise; whether there is an actual antagonism between the state and Federal statutes or not, the state cannot enter the field occupied by the Federal jurisdiction for the purpose of supplementing Federal action. There are border line cases, but the facts here present no such case.

Northern Pacific R. Co. v. *Washington*, 222 U. S. 370;
Erie R. Co. v. *People*, 233 U. S. 671;
Southern R. Co. v. *Reid*, 222 U. S. 424;
Adams Express Co. v. *Croninger*, 226 U. S. 491;
Chicago, R. I. & P. Railway Co. v. *Hardwick Elevator Co.*, 226 U. S. 426;
St. Louis, I. M. & S. Ry. Co. v. *Edwards*, 227 U. S. 265;
McDermott v. *Wisconsin*, 228 U. S. 115;
Michigan Central R. Co. v. *Vreeland*, 227 U. S. 59;
Taylor v. *Taylor*, 232 U. S. 363;
Southern R. Co. v. *Indiana*, 236 U. S. 439;

Charleston & C. R. Co. v. *Varnville Furniture Co.*, 237 U. S. 597;
Texas & Pacific R. Co. v. *Rigsby*, 241 U. S. 33;
New York Central R. Co. v. *Winfield*, 244 U. S. 147;
Pennsylvania R. Co. v. *Public Service Commission*, 250 U. S. 566;
Postal Telegraph Cable Co. v. *Warren Godwin Co.*, 251 U. S. 27.

The act applies to the property as a whole and to all its parts and only one depreciation charge can be applied.

The *transmission* (messages) can be and is divided into interstate and intrastate transmission, subject to regulation by Congress and the state legislatures respectively. But the whole *property* is devoted to both services and *cannot be divided.*

There is no dispute whatever about the *facts* in this respect, and could be none. Everyone knows, for example, that a man having one of the Company's telephones in Hoboken may call central to talk to another telephone in Hoboken—a transaction in *intrastate* commerce, which utilizes the telephone instrument, the wires, poles, crossarms, conduits, cables, central office switchboard, central office building, etc., the whole telephone mechanism. The Hoboken subscriber may next call central for a connection directly across the river with a telephone in New York City and upon obtaining such connection the whole property is used in an *interstate* transaction.

But the life in service of each one of the enumerated parts of the plant is a unit and cannot be divided into an interstate life and an intrastate life. The salvage that will be recovered when the unit is retired from the plant for any cause is a unit and cannot be divided. These service lives and the salvage determine the depreciation rate, and the rate cannot be divided. The depreciation rate, therefore,

cannot be regulated by both the state and federal governments at the same time. One of them must yield and, of course, it is the state authority that must yield. *The segregation of values* on the basis of relative use in interstate and intrastate commerce, for the regulation of rates for the service, is an entirely different thing. That can be and is made.

The Interstate Commerce Commission requires the depreciation expense to be accounted for on a company-wide basis and without reference to state lines. The Company owns and operates telephone plant in three states, New Jersey, New York and Connecticut. If the New Jersey Board has jurisdiction over this subject, the New York Commission likewise has, and the Connecticut Commission; and the Company will be subjected to three sets of regulations, three different schedules of rates. While the New Jersey Board at present seems to accept the straightline method, the New York and Connecticut Commissions may prefer the sinking fund method or some other of the many methods which have their supporters. Even if they agreed as to the method they would disagree as to the rate. If these things may be done with respect to telephone companies, they may also, as a matter of law, be done with respect to railroads.

For the reasons above stated in this point the order of the Board is void.

POINT III.

Without regard to the questions argued in the foregoing points the preliminary injunction properly was granted upon all the evidence before the Court below.

1. The order of the Board if enforced would confiscate the property of the Company by reducing its value more than $14,000,000. The Board erred both in law and in fact in its finding as to the value of the property.

The average value figure for 1924 found by the Board is $76,370,000 for the total property, both intrastate and interstate (R. 32), which is but slightly over the average *cost* figure for that year—$76,247,000 (R. 92). The Company's average value for that year is $91,000,000 (R. 92).

It appears from the decision of the Board that while it professes to have taken note of the rule of *present value* announced in *Smyth* v. *Ames*, 169 U. S. 466 (R. 27), it did not give due weight and consideration to the rules of valuation established by the later cases. Its decision (Table, R. 25) shows the value of the entire property in New Jersey on June 30, 1924, as claimed by the Company based on reproduction cost less depreciation. These figures are compared below with the value as of the same date found by the Board (R. 32):

	Company's figures	Board's figures	Amount allowed the Bo
Tangible Fixed Capital, Depreciated	$74,041,743	$71,000,000	$ 3,041
Going Value	11,782,000	3,600,000	8,182
Working Capital	2,571,900	1,770,000	801
Construction in Progress	2,190,425	disallowed	2,190
Totals	$90,586,068	$76,370,000	$14,216

The Company contends that there was no justification whatever for this disallowance of more than $14,000,000 of value and that the Board erred both in law and in fact in so doing.

We will discuss briefly the errors committed by the Board in reducing and disallowing the value of the items referred to in the above table:

A—Tangible Fixed Capital.

The Board disallowed $3,041,743 of the value of this item as shown in the Company's appraisal. The figure arrived at by the Board is a compromise between several figures (see Table, R. 25). The appraisal made by the Company was practically unchallenged and even the modification of the Company's figure as made by Mr. Wray (one of the Board's engineers) gives a result $533,673 higher than the value found by the Board (R. 25). The modification made by Mr. Wray was based upon an arbitrary assumption that in estimating the cost of reproduction the Company's engineers had not sufficiently taken into consideration the economies obtainable if the plant were to be reproduced as an entirety (R. 23).

B—Going Value.

The Board disallowed $8,182,000 of going value. No estimate of going value was made by the Board's engineers. There was no evidence submitted to the Board except that introduced by the Company which consisted of an estimate by its Valuation Engineer, Mr. Whittemore, based on reproducing the business and organization of the Company, and the testimony of Mr. William H. Blood, Jr., an engineer of wide experience, as to the amount which, in his opinion, should be allowed. Affidavits by Messrs. Whittemore and Blood, similar to the evidence given by them before the Board, are among the supporting affidavits in this suit (R. 80, 81, 114, 115). The evidence of Messrs. Whittemore and Blood was uncontradicted but the Board preferred to make

its finding as to going value "by the exercise of ordinary business judgment" (R. 28). This can be interpreted only to mean that the Board contends that it may make an estimate of going value on a purely arbitrary basis without regard to the evidence before it. This is contrary to judicial decision.

Ohio Utilities Co. v. *P. U. C. of Ohio*, 267 U. S. 359, 362.

Westinghouse El. & M'f'g Co. v. *Denver Tramway Co.*, 3 Fed. (2d) 285, 298.

C—Working Capital.

The Board disallowed $801,900 of the working capital shown in the Company's appraisal. The Company's estimate of working cash was based on the actual amounts carried by the Company for several years preceding (R. 80), supported by the testimony of a Vice President of the Company that the maintenance of such cash balances was necessary for the proper management of the business (R. 30). The Board's expert, who admitted that he had had no experience in financial management, arbitrarily reduced the amount of working cash by about sixty per cent. and upon this opinion the Board based its finding. This was a clear attempt to usurp the discretion and powers of the Company's managers.

D—Construction in Progress.

The Board excluded all construction in progress, the amount being $2,190,425 (R. 24-25). The Company claimed that the amount represented by work in progress should bear a full return, credit, however, being allowed for interest during construction (R. 24). Dollars which have been invested in plant not yet in service have been as irrevocably committed to the enterprise as the dollars invested in completed plant and no distinction should be made as to the return thereon. *The Board did not question the amount involved nor did it claim that such construction was unnecessary or improper.*

Ohio Utilities Co. v. *P. U. C. of Ohio, supra.*

The Board's erroneous valuation prevents the Company from earning on a proper rate base:

The Company is confident that it can establish upon the trial with detail proof the value of its property set forth in its Bill (R. 6-7) and affidavits (R. 81-2) and also the amount of the additions thereto made since June 30, 1924. In view of the opposing contentions of the parties the fair and reasonable value can be established definitely only on the trial but the Company should not in the meantime be subjected to an irreparable loss of return upon $14,000,000 of property if its contentions are correct. At the rate of return found by the Board to be fair (7½%) such loss would amount to $1,050,000 annually.

2. The Board did not meet the proof of the Company as to the cost and value of its *intrastate* property or as to the results of the operation of its *intrastate* business under the telephone rates enjoined.

There was a complete failure on the part of the Board to meet the proof of the Company as to the cost and value of its intrastate property and the results of the operation of its intrastate business.

The opposing affidavits make some criticism of the method of separation between intrastate and interstate property and business employed by the Company (R. 221-223). They also enumerate certain classes of service furnished by the Company in addition to its ordinary exchange and toll telephone service (R. 221-223) and state that the property and business of the Company is not limited alone to intrastate and interstate telephone service as alleged in the moving papers. The Company's affidavits did not specify in detail all of the subsidiary classes of service referred to in the Board's affidavits, but all such business is covered by the accounts prescribed by the I. C. C. Accounting System, and a complete list of said accounts is set up in the Company's papers showing the basis of apportionment of each account between the interstate and

intrastate services furnished by the Company. The apportionment shown in the Company's papers covers *all* of the Company's property in the State of New Jersey as well as *all* of the revenues derived from the use of such property and *all* of the expenses incurred in rendering the services (Replying Affidavits, Addition to Record, p. 13).

The apportionment shown in the Company's affidavits (R. 94-103) is made by the same methods and on the same basis as in the two suits of the Company involving its intrastate property and business in the State of New York, brought in the Southern District of New York in 1922 and 1924 (*Prendergast* v. *N. Y. Telephone Co.*, 262 U. S. 43; *N. Y. Telephone Co.* v. *Prendergast*, 300 Fed. 822). The method of separation in those suits was criticized by the parties defendant but no better method of separation was suggested. In the latter suit the statutory court said (300 Fed. at p. 827):

> "We see no reason to doubt that the various proratings on interstate business have been properly done."

No better method is suggested by the Board in this suit. The engineer for the Board states that he did not make an independent segregation as he did not have the time or the necessary data and information (R. 214). That the data and information were not refused him appears from the Company's replying affidavits (Addition to Record, pp. 1-5).

In this state of the record the Company's proof as to its intrastate property and business stands uncontradicted and the results of the operations of that business under the enjoined service rates were as stated in the following sub-point.

3. The telephone rates enjoined did not produce and could not produce a fair return upon the value of the Company's property, nor even upon its cost. This is so whether the entire property and business be considered or the intrastate property and business alone.

Return on value:

The percentages of net revenue claimed to have been earned by the Company under the enjoined service rates in the years 1922, 1923 and 1924, and as estimated for the year 1925, to the average fair and reasonable value of the property in those years are as follows:

Year	Entire operations in New Jersey	Intrastate operations in New Jersey
1922	4.34%	0.76%
1923	4.42%	1.10%
1924	3.75%	0.42%
1925 (*est.*)	3.57%	0.40%

(R. 6, 7, 85-93.)

Return on the Board's valuation:

The net earnings of the Company for the year 1924 under the enjoined rates were $3,409,000 (R. 92), which is a return of only 4.46% on the value ($76,370,000; R. 32) of the entire property, both intrastate and interstate, adopted by the Board itself.

Return on Cost:

In 1924 the Company from its entire operations in New Jersey earned only 4.47% on the cost of its property (R. 92) and only 0.50% on the intrastate business alone (R. 87).

The effect of the enjoined service rates during the years 1922 to 1925 inclusive as shown by the Board's affidavits:

In its opposing affidavits the Board sets forth figures (R. 215-218; 211) which purport to show the result of the entire

operations (both intrastate and interstate) upon the basis of the enjoined rates from 1922 to 1925 inclusive, *assuming that its rates for depreciation expense had been in force throughout that period and also assuming the value of the property to be reduced in accordance with its findings.* Its figures even after doing this violence to the actual expense and value show that the highest return to the Company which it can compute was 6.79% in 1922, and that such return has been declining steadily and that by the same process of calculation the net return during 1925 would be only 4.93% (R. 211).

The Company was clearly entitled to interlocutory relief upon such a showing:

The Company's right to a preliminary injunction is clear whether the return is estimated as a percentage of *value* or of *cost,* and whether the test is applied to the entire property and operations of the Company within the State of New Jersey or to the intrastate property and business alone. On either basis, value or cost, the enjoined service rates are confiscatory. They are also confiscatory upon the rate base adopted by the Board.

Under such circumstances a preliminary injunction was properly granted.

The Minnesota Rate Cases, 230 U. S. 352, at pages 470-472;

Missouri Rate Cases, 230 U. S. 474 at pages 507-508.

4. The order of the Board requires the Company to charge for depreciation expense an amount less than the actual expense of depreciation and hence if enforced would work continuing confiscation of the Company's property.

The order of the Board prescribes the rates upon which the depreciation expense of the Company shall be computed after January 1, 1925 (R. 16-17).

In its decision the Board shows the results of the application of its schedule of depreciation expense rates as com-

pared with the Company's schedule when applied to the operations during the year 1924. In the table of figures given by the Board (R. 38) the expense of depreciation in 1924 is stated to be as follows:

Depreciation expense computed at the Company's rates	$3,452,000
Depreciation expense computed at the Board's rates	2,678,000
Difference	774,000

In the estimate of operations for the year 1925 given by the Board in its opposing affidavits the expense of depreciation for that year is estimated to be as follows (R. 211):

Depreciation expense computed at the Company's rates	$4,128,000
Depreciation expense computed at the Board's rates	3,314,716
Difference	813,284

With the growth of the property these differences will be increased in future years. This requirement of the Board that the Company shall charge to expense so much less than the true amount of expense accruing in each year clearly confiscates the property of the Company in that it will compel the Company to operate without making adequate provision for one of its necessary operating costs.

The determination of proper depreciation rates is peculiarly a question of management:

It involves engineering studies of the Company's actual experience and the exercise of business judgment as to the proper provision to be made for the future. It further involves large questions of policy as to the adoption of new types of equipment to be substituted for existing types. The financial credit of a utility may be seriously affected by the result of this determination. It is highly important

to allow the management a proper discretion, for upon the management rests the responsibility for the utility's financial policy, for the maintenance of its service and for the protection of its property. *Such discretion should not be overridden in the absence of proof that it has been abused.*

There is also an element of sound business judgment as to the amount to be carried in the reserve balance over and above the actuarial or engineering calculations which are the principal bases of the credits to such reserve and the corresponding charges to expense.

In discussing the depreciation expense and the depreciation balance of this Company the statutory court in *New York Telephone Co.* v. *Prendergast*, 300 Fed. 822, recognized the fact that the book charges for depreciation should represent what the observation and experience of the management "suggested as likely to happen, with some margin over" (p. 825).

This Court in *Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U. S. 276, 277, announced the rule that:

> "A State Commission, in fixing the rates of a public utility corporation, cannot substitute its judgment for the honest discretion of the company's board of directors respecting the necessity and reasonableness of expenditures made in the operations of the company."
> (Headnote.)

See also,

Banton v. *Belt Line R'y Corp.*, 268 U. S. 413, 421.
Southwestern Bell Telephone Co. v. *City of Fort Smith*, 294 Fed. 102, 108.
Northwestern Bell Tel. Co. v. *Spillman*, 6 Fed. (2d) 663, 665.

Obviously, it is to the interest of the management and the Company's stockholders to keep the expenses as low as is consistent with proper maintenance and protection of the property in order that as much revenue as possible may be available currently for dividends, because amounts once credited to the account for depreciation cannot be diverted to any other use.

If the rates prescribed by the Board are insufficient to provide for the currently accruing expense, distributing such expenses as evenly as possible throughout the life of the depreciating property, then the order of the Board would cause the Company to enter upon its books an amount of expense not representative of the true condition and which will not meet the true expense that the Company is incurring. It is the opinion of the Company's managers and engineers that the rates prescribed by the Board would fail substantially to meet the charges properly to be made to expense on account of depreciation losses currently accruing (R. 13; 124). The Board contends that the Company's depreciation rates are too high but such contention is a mere adoption of the opinion of an engineer who has had no managerial nor financial experience.

The Board's order in this regard is illegal:

No abuse of discretion or impropriety upon the part of the Company's management in determining its depreciation expense rates has been shown or suggested and yet the Board has disregarded completely the management's ripened judgment and made an order which, if enforced, would prevent the Company from charging to depreciation expense in the year 1925 upwards of $813,000 of actual and proper expense. The order of the Board in this regard is quite as illegal and hurtful to the Company's property and interests as the part of the order which prevented any increase in the telephone service rates.

POINT IV.

There was no abuse of discretion by the Court below.

Whether a preliminary injunction should be granted rests in the sound discretion of the statutory court. Except for strong reasons this Court will not interfere with its action.

Prendergast v. *New York Telephone Co.*, 262 U. S. 43, 51-52;

Chicago Great Western Ry. Co. v. *Kendall*, 266 U. S. 94, 100;

Meccano, Ltd. v. *Wanamaker*, 253 U. S. 136, 141;

Monroe Gaslight & Fuel Co. v. *Michigan P. U. C.*, 292 Fed. 139, 144-145;

City of Amarillo v. *Southwestern Tel. & Tel. Co.*, 253 Fed. 638, 640;

Van Wert Gaslight Co. v. *Public Utilities Commission of Ohio*, 299 Fed. 670, 676.

In *Prendergast* v. *New York Telephone Co.*, 262 U. S. 43, this Court said at pages 50-51:

> "It is well settled that the granting of a temporary injunction, pending final hearing, is within the sound discretion of the trial court; and that, upon appeal, an order granting such an injunction will not be disturbed unless contrary to some rule of equity, or the result of improvident exercise of judicial discretion. *Meccano, Ltd.* v. *John Wanamaker*, 253 U. S. 136, 141; *Lore* v. *Atchison Railway*, *supra*, p. 331; and cases there cited. Especially will the granting of the temporary writ be upheld, when the balance of injury as between the parties favors its issue. *Amarillo* v. *Southwestern Telephone Co.* (C. C. A.), 253 Fed. 638, 640."

In the case at bar there is nothing to suggest an abuse of discretion by the court below. If the preliminary injunction had not been granted the Company would have suffered an

irreparable and substantial loss of revenue. On the other hand, the subscribers have been protected fully by the bond furnished by the Company (R. 243). The Company could only be protected by the preliminary injunction.

Conclusion.

It was the opinion of the statutory court after lengthy argument and due consideration of all the evidence before it that the order of the Board was confiscatory and invalid and that its enforcement should be enjoined pending the trial of the suit (R. 240).

The order of the court below should be affirmed.

Respectfully submitted,

CHARLES M. BRACELEN,
THOMAS G. HAIGHT,
CHARLES T. RUSSELL,
FRANKLAND BRIGGS,
Counsel for Appellee.